

impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.¹⁷ The Commission believes that the proposal to list and trade the PLUS will provide investors flexibility in satisfying their investment needs by providing them with the opportunity to obtain leveraged returns based on the Nasdaq-100 Index, subject to the Maximum Payment at Maturity. Specifically, as described more fully above, if the value of the Nasdaq-100 Index has increased, a beneficial owner will be entitled to receive at maturity a payment on the Notes based on triple the amount of any percentage increase in the Index, subject to the specified Maximum Payment at Maturity.

The Commission notes that the PLUS are leveraged debt instruments and that their price will be derived and based upon the performance and value of the Nasdaq-100 Index. In addition, as discussed more fully above, the Notes do not guarantee any return of principal at maturity. Thus if the Index has declined at maturity, a beneficial owner may receive significantly less than the original public offering price of the Notes. Accordingly, the level of risk involved in the purchase or sale of the PLUS is similar to the risk involved in the purchase or sale of traditional common stock. In addition, because the final rate of return of the PLUS is derivatively priced and is based on the performance of an index of securities, because the Notes are debt instruments that do not guarantee a return of principal, and because investors' potential return is limited by the Maximum Payment at Maturity, there are several issues regarding the trading of this type of product.

The Commission notes that Nasdaq's rules and procedures that address the special concerns attendant to the trading of hybrid securities will be applicable to the PLUS. In particular, by imposing the hybrid listing standards, suitability, disclosure, and compliance requirements noted above, the Commission believes Nasdaq has addressed adequately the potential problems that could arise from the hybrid nature of the PLUS. Moreover, Nasdaq will distribute a circular to its membership calling attention to the specific risks associated with the PLUS.

In approving the product, the Commission recognizes that the components of the Nasdaq-100 Index may change each year over the life of

the product. Nevertheless, the Commission believes that this is acceptable because Nasdaq has clearly stated its guidelines and formula for replacing components from a specific group of the largest and most actively traded securities listed on the Nasdaq, including companies across a variety of major industry groups. Each year, as noted above, the index of securities comprising the Nasdaq-100 Index will represent the 100 largest non-financial companies listed on The Nasdaq National Market tier of Nasdaq. Nasdaq will do the calculation for replacements based on a set formula to determine which of the securities will be in the Nasdaq-100 Index for the following year. The Commission believes that within these confines the potential changes in the components of the Nasdaq-100 Index are reasonable and will meet the expectation of investors.

In addition, the Commission notes that, unlike traditional debt securities, the PLUS are non-principal protected. The PLUS will not have a minimum principal amount that will be repaid and may be less than the original issue price of the PLUS. The Commission also notes that the PLUS will be registered under section 12 of the Act and will be treated as equity securities, subject to NASD and Nasdaq's existing equity trading rules, including rules on suitability, margin, disclosure, trading hours, and surveillance.

Nasdaq represents that the PLUS meet NASD requirements for depository eligibility under NASD Market Place Rules 4310 and 11310 for purposes of clearance and settlement. The Commission notes that Morgan Stanley will deliver a prospectus to investors with the initial purchase of the PLUS. In addition, Nasdaq will issue a circular to NASD members explaining the unique characteristics and risks of the PLUS. The circular will also note NASD member and member organization responsibilities under Marketplace Rule 2310 and IM-2310-2. Specifically, NASD members must have reasonable grounds for believing that a recommendation to a customer regarding the purchase, sale or exchange of any security is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

Furthermore, the Commission notes that the PLUS are dependent upon the individual credit of the issuer, Morgan Stanley. To some extent this credit risk is minimized by Nasdaq's listing standards in NASD Marketplace Rule 4420(f), which provide the only issuers satisfying substantial asset and equity

requirements may issue securities such as the PLUS. In addition, Nasdaq's hybrid listing standards further require that the PLUS have at least \$4 million in market value.¹⁸ In any event, financial information regarding Morgan Stanley, in addition to the information on the issuers of the underlying securities comprising the Nasdaq-100 Index, will be publicly available.¹⁹

The Commission also has a systemic concern, however, that a broker-dealer, such as Morgan Stanley, or a subsidiary providing a hedge for the issuer will incur position exposure. As discussed in the prior approval orders for other hybrid instruments,²⁰ the Commission believes this concern is minimal given the size of the PLUS issuance in relation to the net worth of Morgan Stanley.

The Commission also believes that the listing and trading of the PLUS should not unduly impact the market for the underlying securities comprising the Nasdaq-100 Index or raise manipulative concerns. The Commission notes that the Index is determined, composed, and calculated by Nasdaq according to objective, publicly-available criteria. As of May 31, 2003, the adjusted market capitalization of the securities included in the Nasdaq-100 Index ranged from a high of \$170.3 billion to a low of \$2.2 billion. The average daily trading volume for these same securities for the last five months, as of the same date, ranged from a high of 68.1 million shares to a low of 527,400 shares. Given the large capitalizations, liquid markets, and relative weightings of the Index's component stocks, the Commission continues to believe, as it has concluded previously, that the listing and trading of the Notes that are linked to the Nasdaq-100 Index should not unduly impact the market for the underlying securities comprising the Nasdaq-100 Index or raise manipulative concerns.²¹ First, the underlying securities comprising the Nasdaq-100 Index are well-capitalized, highly liquid stocks listed on the Nasdaq. Second, the Commission believes that the weighting and potential quarterly rebalancing of the Nasdaq-100 Index should ensure that no single stock or group of stocks will likely dominate the Nasdaq-100 Index, significantly minimizing the potential for manipulation of the index.

¹⁸ See NASD Marketplace rule 4420(f).

¹⁹ The companies that comprise the Nasdaq-100 Index are reporting companies under the Act.

²⁰ See, e.g., Securities Exchange Act Release No. 44913, (October 9, 2001), 66 FR 52469 (October 15, 2001) (SR-NASD-2001-73) (order approving the listing and trading of notes issued by Morgan Stanley Dean Witter & Co. whose return is based on the performance of the Index).

²¹ See n. 8, *supra*.

¹⁷ In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).